The Tax Adviser

Current Developments in Taxation of Individuals

By David R. Baldwin, CPA; Robert Caplan, CPA; Valrie Chambers, Ph.D., CPA; Edward A. Gershman, CPA; Jennifer S. Korten, CPA; Darren Neuschwander, CPA; Jeffrey A. Porter II, CPA; Kenneth L. Rubin, CPA; David E. Taylor, CPA; and Donald J. Zidik Jr., CPA
Today

EXECUTIVE SUMMARY

- Proposed regulations would eliminate the requirement to include a copy of a Sec. 83(b) election with a taxpayer's return.
- The IRS issued final regulations that provide rules regarding the term "taxpayer" for purposes of applying the exclusion from gross income of cancellation-of-debt income of a grantor trust or a disregarded entity.
- The IRS acquiesced to the Ninth Circuit's *Voss* decision, in which the court held that the Sec. 163(h)(3) mortgage deduction limits apply on a per-individual basis.
- Rev. Proc. 2016-53 extended the time in which taxpayers in disaster areas can elect to claim casualty losses on their tax return for the year preceding the disaster year.
- The IRS ruled that the unexpected birth of a child counted as an unforeseen circumstance, which allowed the taxpayers to exclude gain from the sale of their principal residence without meeting the normal two-out-of-five-year requirement.

This article covers recent developments in the area of individual taxation, including cases involving trade or business expenses; proposed regulations on the Sec. 83(b) election; IRS acquiescence in a case involving mortgage deductions; and a taxpayer-friendly ruling on unforeseen circumstances and the sale of a principal residence. The items are arranged in Code section order.

Sec. 36B: Refundable Credit for Coverage Under a Qualified Health Plan

In the case *U.S. House of Representatives v. Burwell*,[1] the U.S. House of Representatives sued the secretary of the Health and Human Services Department for violating Article 1, Section 9, Clause 7, of the U.S. Constitution by spending monies not approved by Congress when the Patient Protection and Affordable Care Act (PPACA) was passed in 2010.[2] This case involves Sections 1401 and 1402 of PPACA. Section 1401 provides tax credits to make insurance premiums affordable (it enacted Sec. 36B, the premium tax credit) and was funded by adding it to the list of permanently appropriated tax credits and refunds in PPACA. Section 1402 reduces deductibles, co-pays, and other means of "cost sharing" by insurers and was not funded in PPACA.

The question before the court was whether Section 1402 can be funded through the same permanent appropriation as Section 1401. The District Court for the District of Columbia ruled that there was no justification for funding Section 1402 reimbursements through the same permanent appropriation as funded Section 1401 and therefore prevented the use of unappropriated monies to fund reimbursements under Section 1402. The court also issued an injunction enjoining any further reimbursements under Section 1402 until a valid appropriation was in place, but stayed the injunction pending any appeal.

Sec. 61: Gross Income Defined

Dynasty trust's life insurance contract: In *Estate of Morrissette*,[3] the Tax Court ruled that because a dynasty trust received no additional benefit beyond that of the current life insurance protection, the trust was the deemed owner of the life insurance contract. As a result, the economic benefit regime applies to the split-dollar life insurance arrangements.

In this case, the decedent created dynasty trusts benefiting her three sons and their respective families. A buy-sell agreement was then entered into that provided that, upon the death of a son, the surviving sons and their dynasty trusts would purchase the deceased son's interest in a family company. As part of this agreement, the dynasty trusts and the decedent's revocable trust entered into a split-dollar life insurance arrangement.

The court ruled that as the dynasty trusts had no current or future access to the cash value of the policies and no economic benefit beyond current life insurance protection that was provided, the revocable trust was the deemed owner of the policies and thus the economic benefit regime was appropriately applied to value the decedent's gifts to the dynasty trusts.

Settlement proceeds: The IRS announced[4] that it disagreed with the Tax Court in *Cosentino*,[5] in which the court concluded the settlement proceeds the taxpayers received from their accounting firm were excludable from gross income. The taxpayers held an interest in a partnership and, on the advice of their accounting firm, entered into an abusive tax shelter to artificially increase their basis in the partnership. They later disposed of their interest in the partnership in a like-kind exchange and recognized a small gain, although none of the deferred gain was recognized. Upon learning that the transaction was an abusive tax shelter, the taxpayers filed an amended return to report their participation in the tax shelter and sued their accounting firm.

The Tax Court held that the settlement proceeds received from the lawsuit were not required to be reported as gross income as they were excludable from income because the proceeds represented a return of lost capital.

In its nonacquiescence, the IRS explained that it believed the settlement proceeds the taxpayers received were compensation from the accounting firm for a portion of the federal income tax the taxpayers owed, not a restoration of lost capital. As a result, the IRS believed the settlement proceeds should be included in the taxpayers' gross income.

Sec. 71: Alimony and Separate Maintenance Payments

Among other issues, the *Leslie*[6] case addressed whether a taxpayer must report as alimony income received from her ex-husband under a marital settlement agreement (MSA). The MSA gave the taxpayer the right to 10% of any fee her former husband, an attorney, received for representing a certain client. The Tax Court concluded that this payment was in fact alimony since, under California law, the payments would have terminated upon the taxpayer's death. Accordingly, the court ruled the payment constituted alimony rather than a property settlement.

While the taxpayer was entitled to the alimony payment in the year the IRS claimed, she was not required to report the alimony until the subsequent year. For the year under review, the taxpayer's former spouse deposited the funds into an account that the taxpayer did not open herself. As the taxpayer was not aware of the funds deposited, had no control of the funds, and did not have constructive receipt of the funds, the alimony was not reportable until the subsequent year when the taxpayer in fact became aware of the funds.

Sec. 72: Annuities; Certain Proceeds of Endowment and Life Insurance Contracts

In IRS Letter Ruling 201625001, the taxpayer, who intended to roll over a distribution from Annuity 1 into Annuity 2, instead mistakenly had the funds deposited into his checking account. The taxpayer later contributed the erroneously distributed funds to Annuity 2. The taxpayer requested a ruling from the IRS that the transaction be treated as a tax-deferred exchange under Sec. 1035(a)(3). The IRS ruled that the transaction did not qualify as an exchange and was taxable in the year the proceeds were received.

Sec. 83: Property Transferred in Connection With Performance of Services

The IRS issued final regulations,[7] applicable to property transferred on or after Jan. 1, 2016, that eliminate the requirement that a copy of a taxpayer's Sec. 83(b) election be attached to and submitted with the taxpayer's individual return for the year in which the election is made.

When an individual is compensated with property for services he or she has performed, the difference between the fair market value (FMV) of the property and the amount paid for the property is included in the individual's income in the tax year his or her right to the property is transferable or no longer subject to a substantial risk of forfeiture. If the individual files an election under Sec. 83(b) no later than 30 days after the date the property is transferred, he or she instead includes the property's FMV in income at the time of the transfer.

Before the IRS issued this regulation, taxpayers were required to attach their Sec. 83(b) elections to their individual income tax returns, which the IRS learned many taxpayers wishing to e-file were unable to do because commercial tax software did not always permit a copy of the election to be attached to the e-filed return. To address this problem, the regulations eliminate the requirement that a taxpayer submit a copy of the election with his or her tax return. The taxpayer must still file an Sec. 83(b) election with the IRS no later than 30 days after the date that the property is transferred to the taxpayer.

Sec. 104: Compensation for Injuries or Sickness

A number of taxpayers were denied exclusion under Sec. 104 for damages paid that were not related to personal physical injury or personal sickness. In *Braddock*,[8] the payment by a long-term care company to avoid the cost of litigation did not qualify as a claim for personal injuries or sickness. In *Tritz*,[9] the district court ruled in summary judgment that the payments received were for emotional distress and not physical injury or sickness. In *George*,[10] the Tax Court ruled that payments for workplace discrimination were not excludable under Sec. 104 as they were not related to physical injury or sickness.

Sec. 108: Cancellation of Debt

Definition of "taxpayer": The IRS issued final regulations defining a "taxpayer" for the purpose of excluding cancellation-of-debt (COD) income for bankruptcy and insolvency purposes under Sec. 108 for a grantor trust or disregarded entity.[11] The final regulations are substantially similar to the proposed regulations issued in 2011. For the bankruptcy or insolvency exclusion to apply, the owner of the grantor trust or the disregarded entity must be under the jurisdiction of a court in a Title 11 case. It is not sufficient for the grantor trust or disregarded entity to be in Title 11 bankruptcy while the owner is solvent.

Bank overdraft: In *Newman*,[12] the Tax Court ruled that a taxpayer could exclude COD income due to an overdraft of a bank account under the insolvency provisions of Sec. 108(a)(1)(B). In 2008, the taxpayer opened a bank account at Bank of America, deposited over $8,800 in funds, including a check for $8,500 drawn on his Wells Fargo bank account, and withdrew $8,000. The Wells Fargo check did not clear, and the taxpayer never repaid the funds. In 2011, Bank of America provided the taxpayer with a Form 1099-C, *Cancellation of Debt*, reporting $7,875 of COD Income. The court ruled that since Bank of America had not received any payments in 36 months, the debt was presumed canceled in 2011 under the 36-month nonpayment testing period rule and the taxpayer had COD income that year. But the court also found the taxpayer to be insolvent in 2011 and therefore the COD income was excluded from income.

Life insurance borrowings: Where borrowings on a life insurance policy exceed the cash value of the policy and the insurer cancels the policy, the borrower owes tax on the difference between his total debt and his investment in the policy.[13]

Qualified real property indebtedness: The IRS issued Rev. Rul. 2016-15 to clarify when a real estate developer can exclude COD income under the "qualified real property business indebtedness exclusion" in Sec. 108(a)(1)(D). Sec. 108(a)(1)(D) provides that a taxpayer that is not a C corporation may exclude COD income if the canceled debt is qualified real property business indebtedness (QRPBI). Sec. 108(c)(3)(A) states that QRPBI must be incurred or assumed by the taxpayer in connection with real property used in a trade or business and be secured by that real property. The revenue ruling states that real property that a taxpayer develops and holds for lease in its leasing business is "real property used in a trade or business" for purposes of Sec. 108(C)(3)(A), and thus can qualify for the exclusion while real property that a taxpayer develops and holds primarily for sale to customers in the ordinary course of business is not "real property used in a trade or business" for purposes of Sec. 108(C)(3)(A) and does not qualify for the exclusion. Rev. Rul. 2016-15 obsoletes Rev. Rul. 76-86.

Sec. 121: Exclusion of Gain From Sale of Principal Residence

In Letter Ruling 201628002, the IRS ruled that the unexpected birth of a child qualified as an "unforeseen circumstance" and permitted a married couple an exception to the two-out-of-five-year rule for exclusion of gain on the sale of a personal residence. In general, under Sec. 121(a), to qualify for the exclusion of income from the sale of a personal residence, the taxpayers must have lived in the residence for two out of five of the years preceding the year of the sale. There are limited exceptions to this rule, and the birth of a child is not included in the stated exceptions.

At the time the taxpayers purchased the two-bedroom, two-bath condo, they had one child. The second bedroom was used as the child's bedroom, a home office, and a guest room. The wife unexpectedly became pregnant with a second child, and the family moved to a larger residence. The IRS determined the suitability of the condo materially changed and ruled that the gain on the sale was excludable under the reduced maximum exclusion under Sec. 121(c).

Sec. 162: Trade or Business Expenses

Substantiation: In *Kilpatrick*,[14] the taxpayer was denied certain business deductions under Sec. 162 as a self-employed CPA. The taxpayer started his own CPA business in 2009 after working with an Atlanta CPA firm for approximately 11 years. He was still working with his former firm until the end of 2010 after he started his own business. The taxpayer operated his new business from his home office. He was denied several deductions on his 2009 and 2010 Schedule C, *Profit or Loss From Business*, due to lack of substantiation.

For his automobile expenses, the taxpayer prepared and presented a calendar and printouts from MapQuest, both generated in December 2011. The Tax Court found that neither of these items constituted "adequate records" for such usage given that they had been generated two years after the time the business use of the automobile occurred. Additionally, no deduction was allowed for the furnishings (desk, chairs, and a painting) purchased for his home office, as the court found the items to be antiques that "will retain their value," and the taxpayer offered no proof otherwise.

He was also denied a deduction for a computer he purchased in 2009 as he failed to prove that he used it solely for business given that the computer was not "used exclusively at a regular business establishment" and was not owned or leased by the person operating the business. The taxpayer's continuing education cost was not deductible because the expenses were actually reimbursable by the CPA firm that he worked for as part of the firm's annual CPE requirements. Finally, the court denied a business deduction for his cellphone and home internet service because he failed to substantiate the amount of business and personal use.

Education costs: In *Kopaigora*,[15] the taxpayer was entitled to a deduction for education and travel costs as unreimbursed employee expenses under Sec. 162(a). Although the taxpayer was fired from his job after he started his education, the Tax Court noted that being unemployed did not prevent him from continuing his trade or business as a finance and accounting business manager. Because a new employer hired him in a similar position after graduation, the court held for the taxpayer. The court stated that "the courses petitioner chose to fulfill his degree requirements did not qualify him for a new trade or business because he was not qualified to perform new tasks or activities with the conferral of his degree."

Ordinary and necessary: In *Cole*,[16] the Tax Court denied the taxpayer's unsubstantiated requests for various deductions on Schedule C of his individual income tax return related to his public-speaking business. In this case, the IRS was challenging the timing of payments made by the taxpayer, as well as whether other expenses fit the definition of "ordinary and necessary." The taxpayer was able to provide adequate support for legal and professional fees, bookkeeping fees, and internet and computer-related expenses, as well as a few others. The taxpayer included the majority of these deductions originally on Schedule C. The Tax Court found that these expenses were ordinary and necessary expenses under Sec. 162 that were paid and therefore were deductible. However, the court agreed with the IRS that the expenses for travel, meals, and entertainment were not deductible because the taxpayer had failed to meet the strict substantiation requirements imposed on these types of costs.

Sec. 163: Interest

Mortgage interest: In AOD 2016-02, the IRS acquiesced in the *Voss* decision in the Ninth Circuit.[17] The appeals court reversed an earlier Tax Court decision and held that the mortgage deduction limits under Sec. 163(h)(3) apply on a per-individual basis as opposed to a per-property basis. Therefore, for unmarried co-owners of property, the $1.1 million interest deduction per the Sec. 163(h)(3) limitation is actually $2.2 million.

Written documentation: The case of *Jackson*[18] once again highlights the importance of written documentation and testimony. The Tax Court denied the taxpayer an interest deduction under Sec. 163 for "interest" payments that he made to his "domestic partner" girlfriend. The girlfriend was the sole owner of the residence that the couple occupied as their personal residence, and she was the only individual responsible for the mortgage. The taxpayer made a cash payment each month to the girlfriend to pay the interest-only mortgage. Due to lack of receipts for the payments, along with the lack of any written statement obligating the taxpayer to pay the girlfriend the monthly amount (other than a letter from her stating that the taxpayer paid her $1,000 a

month), the court found that the taxpayer did not have any ownership interest in the residence. It also noted that the girlfriend did not testify and that this testimony "would have been highly relevant to the question [of] whether she and the petitioner had agreed (expressly or impliedly) that he would hold an interest in the property."

Sec. 165: Losses

Disaster loss election: Rev. Proc. 2016-53 was issued on Oct. 13, 2016, and was effective immediately, to provide an additional six months for making an election under Sec. 165(i) to claim a disaster loss in the preceding tax year. The election due date is six months after the due date for filing the taxpayer's federal income tax return for the disaster year (without regard to extension). A taxpayer makes the Sec. 165(i) election with the filing of either an original or amended tax return of the year preceding the disaster year.

Forfeited profits: The Federal Circuit denied the former CEO of Qwest an income tax credit of $17,974,832 for taxes he paid on insider trading profits that he forfeited to the U.S. government. The IRS successfully asserted that the forfeiture was a government penalty, which is not deductible under Sec. 165(c).[19]

The taxpayer was convicted of insider trading and was required to forfeit his net profit of approximately $44 million from his insider trading and pay a fine of approximately $19 million as a result of his criminal conviction. While the Court of Federal Claims allowed a deduction for the forfeited profits, the Federal Circuit reversed the decision and disallowed the deduction. The Federal Circuit concluded that "allowing a deduction in these circumstances would . . . frustrate public policy," and that even though the taxpayer reported the gain from the trading activity as income and paid tax on the gain, the forfeited income is a criminal forfeiture and "must be paid with after-tax dollars, just as fines are paid with after-tax dollars."

Sec. 170: Charitable, etc., Contributions and Gifts

Artwork: In *Kaplan*,[20] an artist was denied her noncash charitable contribution deduction for artwork (postcards) contributed to not-for-profit organizations. The artist deducted an amount equal to 50% of the amount she claimed the organizations were selling the postcards for. The charitable deduction was disallowed because Sec. 170(e)(1)(A) limits the charitable deduction to the taxpayer's basis for any donation of an item if the gain recognized by the taxpayer would be treated as ordinary income if the taxpayer sold the item.

Substantiation: In *Payne*,[21] a married couple's claimed charitable deductions for noncash contributions in 2010 and 2011 were limited to the extent allowed by the IRS. The taxpayers failed the substantiation requirements of Sec. 170(f)(11)(B) for virtually all of the claimed contributions. The couple did not maintain written acknowledgments from the donee organizations, and they re-created a spreadsheet for the IRS during its examination that contained some but not all of the information required to support the deductions. In addition, the court noted that the claimed noncash contributions of $79,000 for 2010 and $90,000 for 2011 represented approximately 46% of the couple's adjusted gross income (AGI) for each year. Since they lived in a 1,600-square-foot home, the court found it unlikely the furniture and other large items the couple claimed to have contributed could have fit in their home.

Appraisal requirements: In *Cave Buttes, L.L.C.*,[22] a partnership and its individual partners were allowed a charitable contribution for a bargain sale of real estate to a governmental entity. The court found that the partnership's appraisal report either complied or substantially complied with the requirements of Regs. Secs. 1.170A-1 and 1.170A-13, and that the appraisal reflected a reasonable value of the real estate.

Sec. 183: Activities Not Engaged in for Profit

Horse breeding: In *Roberts*,[23] the Seventh Circuit reversed a Tax Court decision in part,[24] which disallowed losses from 2005 and 2006 from the taxpayer's horse-breeding activity under Sec. 183, while it allowed the deductions in later years. The Seventh Circuit questioned the Tax Court's reasoning that the startup phase of an activity was a hobby, while the later stages were a business. It also stated that the nine factors provided by Regs. Sec. 1.183-2(b) for determining whether an activity has a profit motive are "open-ended" and that the Tax Court "was not . . . required to apply all of those factors" to the taxpayer. In applying the personal pleasure and recreation factor of Regs. Sec. 1.183-2, the Seventh Circuit also noted that "it may have been a fun business, but fun doesn't convert a business to a hobby."

Car restoration: In another case, the Tax Court allowed a patent attorney deductions for his activity restoring 1955 and 1956 Plymouth cars.[25] The court stated, "Although his manner of carrying on this activity was unsophisticated, it was businesslike." Given the taxpayer's experience of operating a business and his expertise in restoring these specific cars, along with his advertising efforts and associated business travel, the court deemed the activity to be for profit.

Hair braiding: In *Delia*,[26] the Tax Court ruled that the taxpayer's hair-braiding salon business was for profit. Despite little revenue and substantial expenses (mainly rent), along with a history of losses from 2004 to 2012, the court found that the taxpayer had a profit motive. The taxpayer had entered into a long-term lease for a booth in a shopping mall. The court found that it might have been "prudent for her to have exited this business before she did, but the long-term rental contract posed a serious obstacle." The taxpayer closed her business at the conclusion of the lease agreement. Additionally, the court found that there was no personal pleasure in operating the salon activity. "Although petitioner had a nostalgic fondness for hair braiding, sitting in an empty booth in a shopping mall is not as much fun as (say) riding horses."

Aircraft leasing: In another case, the taxpayer failed to prove that he engaged in his aircraft leasing activity for a profit, even though it had some positive cash flow.[27] In applying the nine factors of Regs. Sec. 1.183-2(b), the court found that the taxpayer failed to avoid "avoidable losses" and that "abandoning unprofitable methods can indicate a profit motive." Additionally, the court found that despite the taxpayer's success in unrelated business activities, that success alone does not carry weight in the determination of profit motive for his aircraft leasing activity given that there was no association among the unrelated ventures. Lastly, the fact that the taxpayer had a substantial income from other sources did not support the for-profit motive of the activity. For the years in question (2003 and 2004), the taxpayer reported gross income of $179,787 and $2,980,944 after claiming losses of $517,044 and $773,776, respectively, from the aircraft leasing activity.

Amway products: The multilevel marketing business of selling Amway products was found not to be a for-profit business activity of the taxpayer in *Hess*.[28] The taxpayer reported seven consistent years of Schedule C losses from being a distributor of Amway products. During those seven years, the taxpayer did not seek any outside business advice besides that of his sponsoring distributor; nor was there any overall business plan, invoices to customers, or any financial statements produced for this activity. The only documentation that the taxpayer maintained was receipts to substantiate expenses. Additionally, the taxpayer was not able to provide support for any of his "two to four distributors" he had added to his downline distributors (distributors recruited by the taxpayer) each year from 2005 to 2010. The court concluded that the taxpayer "did not operate [his] Amway activity in a businesslike manner."

Sec. 212: Expenses for Production of Income

In *Jauregui*,[29] the taxpayer was denied unsubstantiated business deductions in relation to claims made on Schedule C of his individual income tax return for various expenses of his carpentry business. The burden of proof in this case fell on the taxpayer to provide the Tax Court with the necessary documentation. Since the taxpayer was able to provide support for only a portion of his claims, the Tax Court primarily held in favor of the IRS, disallowing the majority of his expense deductions and allowing him to deduct only $60 of tax return preparation fees.

Sec. 213: Medical, Dental, etc., Expenses

Substantiation: In *Levi*,[30] married taxpayers failed to fulfill the necessary burden of proof to deduct a large amount of medical expenses claimed on Schedule A, *Itemized Deductions*. The taxpayers provided the Tax Court with an invoice for dental services rendered to the wife, documenting an amount billed and that no balance remained. Although the invoice showed that the wife received dental services in the tax year, it did not prove the husband paid the bill. The second document provided to the court was a pay stub from the taxpayer's S corporation, which listed an amount paid in health benefits for the taxpayer; however, the court found that this did not provide the necessary support to substantiate claims made by the taxpayer, as it did not prove that the taxpayer himself incurred and paid the amount claimed.

AGI threshold: In another case,[31] married taxpayers were disallowed a deduction of medical and dental expenses on Schedule A of their individual income tax return. The taxpayers deducted their unreimbursed medical and dental expenses in excess of the (then) 7.5% AGI threshold for the medical and dental expense deduction for that year. The IRS disallowed the deduction, claiming that the taxpayers' expenses did not exceed the threshold. After reviewing the taxpayers' claimed vehicle expenses for their S corporation, the Tax Court disallowed a substantial portion of the expenses. This increased the taxpayers' AGI and caused the total of the taxpayers' medical and dental expenses to fall below 7.5% of AGI. Thus, the Tax Court upheld the IRS's disallowance of the deduction for the unreimbursed medical and dental expenses claimed by the taxpayers.

In another case,[32] a taxpayer claimed on her Schedule A deductions for medical, dental, and other health care expenses incurred during the tax year. During that year, the amount of the allowable deduction was a taxpayer's qualified expenses in excess of 7.5% of her AGI. However, the taxpayer was able to substantiate only a portion of the amount claimed on her individual income tax return. As a result, the Tax Court allowed her a deduction in the amount that the documented items exceeded 7.5% of AGI, and disallowed the remaining amount initially claimed by the taxpayer.

Sec. 215: Alimony, etc., Payments

Substantiation: In *Levi*,[33] also discussed under Sec. 213, an invalid married-filing-jointly return was originally filed on behalf of two taxpayers, who subsequently were divorced. The proceedings between the IRS and the taxpayers in Tax Court led to the relief of all the wife's tax liability, as she was found to have no filing requirements for the year in question. On the originally filed return, the taxpayers claimed a significant deduction for alimony payments made during the tax year.

As the case progressed and the focus of the Tax Court and IRS fell upon the husband, the burden of proof associated with these alimony payments likewise fell on the husband. He provided documentation for a portion of the total amount claimed on his tax return by providing the Tax Court with two pages from the transcript of a legal proceeding describing a cashier's check paid to the taxpayer's former wife as an alimony payment. However, the taxpayer was unable to substantiate the remaining balance claimed. Due to the lack of substantiation, the Tax Court ruled that the taxpayer could deduct the documented portion of the alimony payments, disallowing the deduction for the undocumented portion.

Penalties: In another case,[34] the taxpayer was assessed a deficiency and accuracy-related penalty due to the disallowance of an amount claimed by the taxpayer on his individual tax return. The IRS had challenged the taxpayer's position that he could deduct a portion of a large amount of alimony paid on his individual tax return. During the examination process, while on a telephone conference with the IRS, the taxpayer conceded his position on the alimony deduction and was required to pay both the deficiency and the accuracy-related penalty.

Sec. 274: Disallowance of Certain Entertainment, etc., Expenses

In *Nawrot*,[35] the taxpayer was denied various deductions she claimed on Schedules A and C of her individual tax return. The taxpayer attempted to claim deductions for unreimbursed expenses associated with four trips made in 2006. However, documentation in the form of the employer's reimbursement logs showed that her employer had reimbursed her for those trips in 2007. The taxpayer further attempted to deduct the cost of steel-toe shoes, which would be deductible if the shoes were required for the taxpayer's employment, unsuitable for general wear, and not worn for personal use. The IRS disallowed the claim because the taxpayer did not provide the necessary documentation to substantiate her claim. The Tax Court further ruled in favor of the IRS for unsubstantiated claims for deductions related to travel, meals and entertainment, and tax preparation fees appearing on Schedule A and Schedule C.

Sec. 469: Passive Activity Losses

Material-participation requirements: In *Gragg*,[36]the Ninth Circuit considered whether rental losses for real estate professionals are automatically entitled to nonpassive treatment under Sec. 469(c)(7). Charles and Delores Gragg, on their 2006 and 2007 tax returns, asserted they met the requirements for real estate professional status because Delores was a full-time real estate agent, which required more than 50% of her personal service time and 750 hours under Sec. 469(c)(7)(B). The Graggs deducted the losses they incurred in 2006-2007 from two rental properties in full as nonpassive losses.

Upon audit, the taxpayers presented no substantiation of participation in the rental activities, contending that since they qualified for real estate professional status, there was no need to further qualify under Sec. 469(c). Additionally, the taxpayers did not make the election under Sec. 469(c)(7)(A) to group the two properties as a single activity (see below). The taxpayers paid the deficiencies for 2006 and 2007 and sought relief in district court. The Ninth Circuit upheld the finding of the district court that taxpayers who qualify for real estate professional status under Sec. 469(c)(7) are still required under Regs. Secs. 1.469-9(e)(1) and -9(e)(3)(i) to meet the material-participation requirements for rental properties, which would not include her time working as a real estate agent.

Late elections for real estate professionals to group rental activities: As a reminder, if a qualifying real estate professional has not made the election to group all of his or her rental activities as a single activity under Sec. 469(c)(7)(A) (and Regs. Sec. 1.469-9(g)(3)), the preparer has two options to correct this omission: (1) by filing the election on an amended return under Rev. Proc. 2011-34 if the taxpayer qualifies, or (2) by seeking an extension of time to make the election by requesting a private letter ruling. In Letter Ruling 201638014, the IRS granted a 120-day extension to the taxpayers to make the election. Under Regs. Sec. 301.9100-3, an extension will be granted if a taxpayer provides evidence of acting reasonably and in good faith, and if the interests of the government are not prejudiced. In this letter ruling, the Service stated that as the taxpayers relied on a tax professional who failed to advise them on making the election, they were "deemed to have acted reasonably and in good faith."

Regrouping authority of the IRS: In Technical Advice Memorandum 201634022, the IRS reviewed the grouping of activities of a taxpayer at the request of the field auditor conducting an examination to clarify whether the activities should be regrouped. The taxpayer was employed by two medical practice S corporations in which he also had ownership interests. The taxpayer reported his net income from a commercial real estate rental partnership as passive, offsetting other passive losses from a condo rental. The commercial rental was a surgery facility, which leased outpatient surgery facilities to the local medical community on an as-needed basis. Other health practitioners in the area used the surgery facilities, and the taxpayer did not limit his procedures to the facility. The taxpayer presented evidence that there was no economic interdependencies between the S corporations and the medical facility.

The passive loss regulations at Regs. Secs. 1.469-4(c)(1) and (2) provide for the grouping of multiple trade or business activities or rental activities when the activities constitute an "appropriate economic unit." If it is determined that a taxpayer's grouping is inappropriate, Regs. Sec. 1.469-4(e)(2) requires the taxpayer to regroup the activities into an appropriate economic unit. Furthermore, the Service has the authority to require a regrouping if it determines an inappropriate grouping has occurred.[37] In this memorandum, the IRS reviewed the examples in Regs. Sec. 1.469-4(f) and applied them to the taxpayer's situation, finding the taxpayer did make an appropriate grouping (by not grouping the real estate rental with the S corporations).

"Facts and circumstances" test: Rental activities of a taxpayer who qualifies as a real estate professional are not treated as *per se* passive activities. To be a real estate professional for purposes of Sec. 469(c)(7)(B), a taxpayer must perform more than 750 hours of services in real property trades or businesses in which the taxpayer materially participates. A taxpayermeets the material-participation requirement for an activity if the taxpayer meets one of the seven tests in Temp. Regs. Sec. 1.469-5T(a), the first six of which involve specific criteria. If the taxpayer does not meet any of these tests, under the seventh test (Temp. Regs. Sec. 1.469-5T (a)(7)), the taxpayer will be considered to materially participate in an activity if, based on all the facts and circumstances, the taxpayer participates in the activity on a regular, continuous, and substantial basis during the year.

In *Hailstock*,[38]the IRS found on audit that the taxpayer did not meet the requirements to establish her real estate professional status for the years 2005-2009, in which she deducted rental losses as nonpassive. The taxpayer owned and managed 30 rental properties in Ohio, but she did not regularly keep time records for her activities and did not present any evidence of having made the grouping election for real estate professionals under Sec. 469(c)(7)(A). Because she did not make the grouping election, the Tax Court considered each property as a separate rental activity for material-participation purposes.

Despite having no proof of her time spent on each activity, the Tax Court found that she met the material-participation test in Temp. Regs. Sec. 1.469-5T(a)(7) for each rental activity because she gave credible testimony that she spent at least 40 hours weekly managing all the properties and provided details as to what her daily activities included, such as monitoring outside contractors, purchasing supplies for the rentals, finding tenants, researching local properties, and educating herself. Because she materially participated in each of her separate rental activities, the Tax Court counted the hours spent on each activity toward the 750-hour requirement to be a real estate professional, and, as a result, the taxpayer qualified as a real estate professional. Consequently, the court held that her rental activities were nonpassive activities since she materially participated in all the activities. (For further discussion of the issues governing whether a taxpayer qualifies as a real estate professional, see "Navigating the Real Estate Professional Rules (/issues/2017/mar/navigating-real-estate-professional-rules.html).")

Sec. 1011: Adjusted Basis for Determining Gain or Loss

The Ninth Circuit in *Obedin*[39] affirmed the Tax Court's decision and concluded that the taxpayers failed to prove payments made were allocable to basis even though the IRS and Tax Court acknowledged that the taxpayers had made payments on real estate projects because the taxpayers were not able to identify the applicable projects for which they made the payments. The Ninth Circuit mentioned the Tax Court's noting inconsistencies between the payment spreadsheets that the taxpayers submitted in court.

Sec. 1033: Involuntary Conversions

The IRS in News Release IR-2016-127 granted farmers and ranchers an extension of time to replace livestock and to defer tax on any gains from forced sales due to drought conditions. Farmers and ranchers who sell more livestock than in the normal course of business due to drought conditions may defer tax on these sales. To qualify, the livestock must be replaced within a four-year period. The IRS may extend this period if the drought continues.

The one-year extension applies to realized capital gains on sales of livestock held for draft, dairy, or breeding purposes. Sales of livestock held for slaughter or sporting purposes are not eligible. Relief is granted to any farm in a county, parish, city, or district listed as under severe drought conditions by the National Drought Mitigation Center during any weekly period from Sept. 1, 2015, through Aug. 31, 2016. The extension immediately affects drought sales that occurred in 2012. Additional information about the relief is available in Notice 2016-60, and IRS Publication 225, *Farmer's Tax Guide*, provides details on reporting drought sales.

Sec. 1041: Transfers of Property Between Spouses or Incident to Divorce

The Tax Court in *Belot*[40] held that a taxpayer's sale of his interests in marital assets qualified for Sec. 1041 nonrecognition treatment under a 2008 settlement agreement that was incident to a divorce. The taxpayer and his ex-wife made two attempts to divide their business interests. The first attempt to divide the marital assets in 2007 failed. The second attempt, in 2008, was completed with the settlement of a lawsuit brought by the ex-spouse.

The IRS argued that the second attempt, in 2008, was not made incident to the divorce as it did not relate to a divorce instrument. The Tax Court cited a Fourth Circuit case in which the appeals court wrote that the intent of Congress under Sec. 1041 was "to treat a husband and wife [and former husband and wife acting incident to divorce] as one economic unit, and to defer, but not eliminate, the recognition of any gain or loss on interspousal property transfers until the property is conveyed to a third party outside the economic unit."[41]

Sec. 1221: Capital Asset Defined

The Eleventh Circuit in *Boree*[42] held that a married couple's bulk sale of property resulted in ordinary income and not capital gain as reported by the taxpayers, who were real estate developers.

The court rejected the taxpayers' argument that the application of land use restrictions on their property was similar to a condemnation and changed their purpose for the property from development to investment use. The court also found evidence that the taxpayers were holding the property for sale in lots in the ordinary course of business from its acquisition of the property right up to the sale and that the taxpayers continued to sell or attempt to sell lots after the restrictions were put in place. The court also agreed with the Tax Court's conclusion that the taxpayers' sale of 60 lots encompassing about 600 acres between 2002 and 2006 constituted "frequent and substantial sales" and that the taxpayers had segregated interior acreage of the

property for investment purposes rather than for inventory purposes. The court also rejected the taxpayers' argument that they were entitled to capital gain treatment simply because the property had appreciated in value, when the sale arose from their engaging in the ordinary course of the business of developing real estate.

Sec. 1402: Self-Employment

The Tax Court sided with the IRS that a taxpayer's vow of poverty did not insulate him from the requirement to pay federal income tax and self-employment tax.[43]

Ronald White, who became a pastor in 1983, recommended to his employer's board of advisers in 2001 that the church be restructured to include a corporation sole as an office of the church. After the corporation sole was established, White undertook a vow of poverty and agreed to divest his property and his future earnings to his church. In exchange, the church would provide for his physical, financial, and personal needs. The church established a bank account that White had signatory authority over.

For the years in question, 200-2009, White did not file a personal income tax return or a timely certificate of exemption from self-employment tax. The IRS filed substitute returns for this period, and at the time of trial the unreported income still at issue was roughly $110,000. White did not contest the amounts determined by the IRS, but he argued that his vow of poverty insulated him from income tax and self-employment tax.

In examining the facts surrounding White's case, the court referred to prior cases of similar factual makeup, mainly *Cortes*, T.C. Memo. 2014-181, *Rogers*,T.C. Memo. 2013-177,and *Gunkle*,T.C. Memo. 2012-305. The court previously held that "a vow of poverty does not insulate a pastor from tax liability even when the pastor receives funds directly from his church in exchange for services rendered if the pastor does not remit those funds to the church in accordance with his vow of poverty, has control over the funds, and uses the funds for personal expenditures." White argued that his circumstance was different. He contested those opinions on the grounds that the cases cited involved individuals earning income from third parties and then assigning that money to their religious order.

The court noted that he appeared to be relying on the initial IRS public pronouncement from 1919,[44] which stated a "clergyman is not liable for any income tax on the amount received by him during the year from the parish of which he is in charge, provided that he turns over to the religious order of which he is a member, all the money received in excess of his actual living expenses, on account of the vow of poverty which he has taken." The court saw this argument as misguided and cited Rev. Rul. 77-290, which superseded O.D. 119 and states that if income received for services performed for the order or on its behalf is remitted back to the order in accordance with the member's vow of poverty, it is not includible in income. Similar to *Cortes* and *Rogers*, the critical difference in White's case was that he did not remit income to the church; rather, he held signatory authority over the bank account, and the payments made by the church to him served only to meet his living expenses. Therefore, the payments must be included in gross income. Because White did not timely file an exemption certificate, the income was subject to self-employment tax under Sec. 1402(c)(4).

Sec. 6015: Relief From Joint and Several Liability on a Joint Return

Innocent spouse claim: The Tax Court sided with the IRS in denying innocent spouse relief to a taxpayer under Sec. 6015(b).[45] Larry and Sletta Arobo, who are married, filed their 2004 return in 2010, and, shortly thereafter, the IRS selected it for audit. While under audit, they also filed returns for tax years 2005-2007. Under examination, it was determined that all of the returns contained significant understatements related to Mr. Arobo's mortgage business, and the necessary interest and penalties were duly applied.

While awaiting the results of a request seeking redetermination of the deficiencies the IRS declared, Mrs. Arobo applied for innocent spouse relief. The IRS conceded that Mrs. Arobo satisfied the requirements of Secs. 6015(b)(1)(A), (B), and (E) but denied her relief under Secs. 6015(b)(1)(C), which requires the spouse to have had no knowledge or reason to know of the understatement, and (D), which allows for relief where it would be inequitable to hold the spouse liable for the understatement.

The court reiterated that the requirements of Sec. 6015(b)(1) are conjunctive and failure to satisfy one prevents relief (*Alt*,119 T.C. 306 (2002), aff'd, 101 F. Appx. 34 (6th Cir. 2004)). Upon examination of the facts of the case, Mrs. Arobo was denied relief because she failed to satisfy the requirements of Sec. 6015(b)(1)(C) by not establishing that she did not know or have reason to know that the returns contained erroneous information. Likewise, the court denied relief under Sec. 6015(f), primarily on the grounds that it would not be inequitable to deny her relief when she should have known of the understatements.

Liability for a portion of the underpayment: On Aug. 15, 2016, the IRS released its 2016-2017 Priority Guidance Plan and included guidance under Sec. 6015 as a priority to clarify proposed regulations released in 2013 and 2015. The preamble to the proposed regulations[46] issued in 2015 state:

> If a requesting spouse remains liable for a portion of the underpayment after application of §1.6015-4, the requesting spouse is not eligible for relief under section 6015 for the penalties and interest related to that portion of the underpayment. Cf. *Weiler v. Commissioner*, T.C. Memo. 2003-255 (a requesting spouse is not relieved from liabilities for penalties and interest resulting from items attributable to the requesting spouse).

This position is consistent with how the IRS currently treats relief from penalties and interest after determining the relief from the underlying tax. See IRM §25.15.3.4.1.1(2) (revised 3/8/13).

However, in *Boyle*,[47] the Tax Court granted relief from failure-to-file and failure-to-pay penalties and interest to Joseph Boyle under the provisions of Sec. 6015(f), even though he did not seek relief from the associated underpayment. Boyle requested relief only from the interest and penalties assessed for the period of 2003-2005. Boyle was self-employed at the time and was the primary income provider. Boyle's wife, Patricia Boyle, typically handled the tax return matters for the family. She would have a professional preparer fill out the returns and bring them to Boyle to sign. Boyle had, in fact, signed a return for 2003 and only learned that his wife had not filed it upon her death from cancer in 2005. Boyle timely filed returns for both 2004 and 2005 and promptly filed the 2003 return in 2005 after learning it had not been filed, but before receiving a notice from the IRS.

The IRS and the Appeals office initially granted partial relief to Boyle for 2004 due to the gambling income reported by his wife for that period. The IRS, however, denied his request for relief for 2003 and 2005 because all of the income reported was attributable to his earnings. This treatment is in keeping with the income attribution threshold outlined in Rev. Proc. 2013-34. The IRS conceded in court that Boyle had cleared the other six established thresholds for relief.

The court rejected the IRS's position because Boyle was not seeking relief from the underlying tax due, merely the interest and penalties assessed. The court also believed that he qualified for relief under a separate threshold from Rev. Proc. 2013-34, because Patricia Boyle's having had him sign the 2003 return and then not mailing it was tantamount to fraud. The Tax Court looked favorably on the fact that Boyle had quickly filed the

2003 return upon learning that his wife had not filed it, signifying there was no deception on his part. In addition, the court cited his history of compliance with the tax laws and his willingness to pay the tax due as factors that helped tip the scales in his favor as they considered granting relief.

Sec. 6695: Other Tax Return Preparation Penalties

The IRS is sending reminder letters to preparers who appear to be making mistakes on the earned income tax credit or who fail to attach the due-diligence checklist, Form 8867, *Paid Preparer's Due Diligence Checklist*. Also, tax preparers filing income tax returns claiming an American opportunity tax credit, a child tax credit, or an additional child tax credit now have to fill out Form 8867. Failure to do so may result in a preparer penalty of up to $510, indexed to inflation, for each failure.

Footnotes

---

[1]*United States House of Representatives v. Burwell*, No. 14-1967 (RMC) (D.D.C. 5/12/16).

[2]Patient Protection and Affordable Care Act, P.L. 111-148.

[3]*Estate of Morrissette*, 146 T.C. No. 11 (2016).

[4]Action on Decision (AOD) 2016-01 (4/4/16).

[5]*Cosentino*, T.C. Memo. 2014-186.

[6]*Leslie*, T.C. Memo. 2016-171.

[7]T.D. 9779.

[8]*Braddock*, T.C. Summ. 2016-46.

[9]*Tritz*, No. SACV 14-1653 AG (C.D. Cal. 6/30/16).

[10]*George*, T.C. Memo. 2016-156.

[11]T.D. 9771 (6/10/16).

[12]*Newman*, T.C. Memo. 2016-125.

[13]*Mallory*, T.C. Memo. 2016-110.

[14]*Kilpatrick*, T.C. Memo. 2016-166.

[15]*Kopaigora*, T.C. Summ. 2016-35.

[16]*Cole*, T.C. Summ. 2016-63.

[17]*Voss*, 796 F.3d 1051 (9th Cir. 2015).

[18]*Jackson*, T.C. Summ. 2016-33.

[19]*Nacchio*, 824 F.3d 1370 (Fed. Cir. 2016), aff'g in part and rev'g in part and remanding 115 Fed. Cl. 195 (2014).

[20]*Kaplan*, T.C. Memo. 2016-149.

[21]*Payne*, T.C. Summ. 2016-30.

[22]*Cave Buttes*, *L.L.C.*, 147 T.C. No. 10 (2016).

[23]*Roberts*, 820 F.3d 247 (7th Cir. 2016).

[24]*Roberts*, T.C. Memo. 2014-74.

[25]*Main*, T.C. Memo. 2016-127.

[26]*Delia*, T.C. Memo. 2016-71.

[27]*Hoffman*, T.C. Memo. 2016-69.

[28]*Hess*, T.C. Summ. 2016-27.

[29]*Jauregui*, T.C. Summ. 2016-39.

[30]*Levi*, T.C. Memo. 2016-108.

[31]*Powell*, T.C. Memo. 2016-111.

[32]*Czekalski*, T.C. Summ. 2016-56.

[33]*Levi*, T.C. Memo. 2016-108.

[34]*Cooper*, T.C. Summ. 2016-54.

[35]*Nawrot*, T.C. Summ. 2016-50.

[36]*Gragg*, 831 F.3d 1189 (9th Cir. 2016).

[37]Regs. Sec. 1.469-4(f)(1).

[38]*Hailstock*, T.C. Memo. 2016-146.

[39]*Obedin*, No. 14-70487 (9th Cir. 7/21/2016).

[40]*Belot*, T.C. Memo. 2016-113.

[41]Id. at *12, quoting *Young*, 240 F.3d 369, 375 (4th Cir. 2001), in turn quoting *Blatt*, 102 T.C. 77, 80 (1994).

[42]*Boree*, No.14-15149 (11th Cir. 9/12/16).

[43]*White*, T.C. Memo. 2016-167.

[44]Office Decision (O.D.) 119, 1919-1 C.B. 82.

[45]*Arobo*, T.C. Memo. 2016-66.

[46]REG-134219-08.

[47]*Boyle*, T.C. Memo. 2016-87.

Contributors

David Baldwin is a partner with Baldwin & Baldwin PLLC in Phoenix. *Robert Caplan* is a CPA at Robert M. Caplan CPA in Foster City, Calif. *Valrie Chambers* is an associate professor of accounting at Stetson University in DeLand, Fla. *Edward Gershman* is a partner with Deloitte Tax LLP in Chicago. *Jennifer Korten* is a partner at Kubo Korten in Seattle. *Darren Neuschwander* is a managing member with Green, Neuschwander & Manning, a virtual CPA firm with members all across the country. *Jeffrey Porter* is a CPA with Porter & Associates CPAs in Huntington, W.Va. *Kenneth Rubin* is a partner with RubinBrown LLP in St. Louis. *David Taylor* is a partner at Anton Collins Mitchell in Denver. *Donald Zidik* is a director with Marcum LLP in Boston and an adjunct professor of taxation at Suffolk University in Boston. Mr. Zidik is the chair, Mr. Rubin is the immediate past chair, and the other authors are current members of the AICPA Individual & Self-Employed Tax Technical Resource Panel (TRP). For more information about this article, contact thetaxadviser@aicpa.org (mailto:thetaxadviser@aicpa.org).